No. 88-1918

In the

Supreme Court of the United States

October Term, 1988

GLEN CORPORATION, ET AL.,
Petitioners,

v.

O.C. ASSOCIATES, ET AL.,
Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT.

BRIEF OF DEBENTUREHOLDERS
PROTECTIVE COMMITTEE IN OPPOSITION.

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Question Presented.

Where a debtor is found to be solvent, does federal bankruptcy law require that creditors be paid interest on the full amount of their claims?

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In the
Supreme Court of the United States

OCTOBER TERM, 1982.

No. 82-106

GLEN CORPORATION, ET AL.,
PETITIONERS,

v.

O.C. ASSOCIATES, ET AL.,
RESPONDENTS.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT.

BRIEF OF DEBENTUREHOLDERS PROTECTIVE COMMITTEE IN OPPOSITION.

Respondent Debentureholders Protective Committee (the "Committee") hereby opposes the petition for a writ of certiorari filed by Glen Corporation, Monte J. Wallace, Neil W. Wallace and the Minority Stockholders' Committee of Continental Investment Corporation in this case.

Statement of the Case.

In April 1973, Continental Investment Corporation ("CIC") offered an issue of straight debentures due on November 1, 1985 (the "straight debentures") in exchange for then outstanding convertible debentures due on November 1, 1990 (the "convertible debentures"). Both the straight debentures and the convertible debentures bore interest at the rate of nine percent per annum and the trust indenture for both the straight debentures and the convertible debentures provided that upon default in the payment of any installment of interest, CIC would pay interest on the overdue installments at the rate of interest borne by the debentures, to the extent permitted by law. (P-3a, 4a.)[1] The straight debentures were, by their terms, deemed to be contracts made under the laws of the State of New York; the convertible debentures were, by their terms, deemed to be contracts made under the laws of the Commonwealth of Massachusetts. *Id.* CIC defaulted on the interest payments due on the debentures on November 1, 1974 and, except as described below, made no interest payments thereafter. (P-4a.)

On April 30, 1976, CIC filed a petition under Chapter XI of the Bankruptcy Act and the proceeding was thereafter converted to a Chapter X proceeding in the United States District Court for the District of Massachusetts.

On June 5, 1981 the Trustee in bankruptcy proposed a Third Modified Plan of Reorganization (the "Trustee's Plan"). As of that date, and thereafter, CIC was a solvent corporation. (P-6a.) The Trustee's Plan provided that holders of straight debentures and convertible debentures would receive the principal amount of the debentures plus all overdue installments of

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[1] References to material in the appendix to the Petition are denoted "P-1a", etc. References to material in the Petition are denoted "P-1", etc.

interest but did not explicitly provide for the payment of any amount on account of interest on the overdue installments. (P-5a, 18a.) On June 18, 1981, the district court approved the Trustee's Plan for submission to stockholders of CIC,[2] however, in ruling on the Trustee's Plan, the district court noted that all parties had agreed to defer the interest on overdue interest issue to some later date. (P-18a.) All parties thereafter submitted memoranda on the issue and, on September 9, 1981, the district court entered a memorandum and order denying the claims of holders of straight and convertible debentures to interest on overdue installments of interest. (P-17a.) The committee duly perfected its appeal from that order. On September 16, 1981, the district court confirmed the Trustee's Plan.

In its appeal to the United States Court of Appeals for the First Circuit (the "Court of Appeals") the Committee argued that the interest on interest provisions of the straight debentures were enforceable in a manner consistent with the express public policy of the State of New York,[3] and that in any case the absolute priority rule required the payment of interest on overdue interest even if not accrued at the contract rate.[4]

The Court of Appeals held that holders of convertible debentures were entitled to interest at the contract rate on all unpaid installments of interest under the laws of the Commonwealth of Massachusetts and that, absent payment of such interest, the Trustee's Plan was not fair and equitable. (P-14a.)[5]

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[2] The district court determined that because CIC creditors were not affected by the Trustee's Plan, that is, they received all to which they were entitled, they were not eligible to vote on the Trustee's Plan.

[3] Brief of Debentureholders Protective Committee at 4-14, in 81-1741.

[4] *Id.* at 14-17. To the extent that the petitioners imply that the Committee made no claim to interest on overdue interest under federal law (*see* P-5, 6), the petitioners are wrong. (*See* P-18 n.28.)

[5] The petitioners have not sought a writ of certiorari with regard to this decision. (P-5 n.4.)

With regard to the straight debentures, the Court of Appeals held that New York law precluded a contractual right to interest on overdue interest and further precluded a non-contractual right to interest on overdue interest accrued prior to the commencement of the CIC Chapter XI proceeding.* (P-15a.) The Court of Appeals also held, however, that under federal bankruptcy law, straight debentureholders were entitled to interest from the commencement of the CIC Chapter XI proceeding at the statutory general rate of eight percent on all unpaid installments of interest. *Id.* Accordingly, the Court of Appeals reversed the decision of the district court.

Argument.

I. The Court of Appeals Properly Decided That There is a Right to Post-Petition Interest Under Federal Bankruptcy Law.

The petitioners raise a great hue and cry over the Court of Appeals' unremarkable statement that "[i]t is a general rule of federal bankruptcy law that if the alleged bankrupt proves solvent, creditors have a right to receive post-petition interest at the statutory general rate . . . before any surplus reverts to the debtor." (P-15a.) While the necessary predicate of the Court of Appeals' statement — a solvent debtor — is rarely encountered, where as here the debtor is solvent, creditors are entitled to be made whole before the stockholders of the debtor receive any distribution of the debtor's assets. As stated by this Court in *Consolidated Rock Products Co.* v. *Du Bois*, 312 U.S. 510 (1941), "'any arrangement of the parties by which the sub-

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*The Committee has not sought review of the Court of Appeals' decision on the effect of New York law and does not press the issue before this Court.

ordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights' of creditors 'comes within judicial denunciation.'" *Id.* at 527 (quoting *Louisville Trust Co.* v. *Louisville, N.A. & C. Ry. Co.*, 174 U.S. 674, 684 (1899)).

A creditor's non-contractual right to receive interest on its claim does not arise from state law, although state law may be applied to determine the proper rate of interest, but rather from the absolute priority rule set down by this Court in *Northern Pacific R.R. Co.* v. *Boyd*, 228 U.S. 482 (1913) and reiterated in *Consolidated Rock Products, supra.* Even where claims do not bear a contractual rate of interest, the absolute priority rule requires that creditors holding such claims be allowed interest at the governing legal rate. *In re Imperial "400" National, Inc.*, 374 F. Supp. 949 (D. N.J. 1974); 6 *Collier on Bankruptcy* § 9.08, at 1583 (14th ed. 1978); *cf. Muskegon Motor Stockholders Protective Committee* v. *Davis* (In re Muskegan Motor Specialties), 366 F.2d 522, 529 (6th Cir. 1966) (in light of absolute priority rule, accrued interest at statutory rate must be added to creditors' claims to determine debtor's solvency).

The petitioners state, however, that creditors are entitled to interest only "if the creditor is otherwise entitled to interest under applicable non-bankruptcy law." (P-9.) This assertion is belied by *Imperial "400", supra*, and common sense. As noted by this Court in *Vanston Bondholders Protective Committee* v. *Green*, 329 U.S. 156 (1946), "[c]ourts have felt that it would be inequitable for anyone to gain an advantage or suffer a loss because of [the] delay" in payment caused by the commencement of bankruptcy proceedings. *Id.* at 164. The petitioners would permit a debtor to use and invest creditors' funds over a period of years and be liable only for the principal

amount of the creditors' claims, the interest or other income thereon to go to the debtor's stockholders.[7]

The Court of Appeals' decision did nothing more than make the straight debentureholders whole for the delay in payment caused by the imposition of the Chapter X proceeding. Had the debtor not sought protection under the bankruptcy law, the straight debentureholders would have received semi-annual payments of interest on outstanding principal. The Trustee's Plan offered the straight debentureholders only the principal amount of the debentures plus such interest as had accrued from November 1, 1974 through October 26, 1981. Under the Trustee's Plan, the straight debentureholders were not accorded any recognition or compensation for the detriment caused by the seven year delay in the payment of interest. Regardless of the straight debentureholder's right to interest on overdue interest under New York law, a right that the straight debentureholders do not press before this Court,[8] the straight debentureholders are entitled to be made whole before the debtor's stockholders share in any distribution. Payment of interest accrued over seven years in a lump sum, with no accounting made for the passage of time, does not make the straight debenture-

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[7] This type of inequitable treatment of creditors' claims was explicitly barred by the United States Congress in enacting the Bankruptcy Reform Act of 1978, 11 U.S.C. prec. 101 (Supp. II 1978) (the "Bankruptcy Code") the statutory successor to the Act under which the instant proceeding was commenced. Section 726(a)(5), (6) of the Bankruptcy Code (11 U.S.C. § 726(a)(5), (6)) provides that unsecured creditors in a Chapter 7 proceeding shall receive interest at the legal rate, from the date of the commencement of the proceeding, prior to any distribution to the debtor. The Chapter 11 reorganization provisions of the Bankruptcy Code incorporate this requirement and provide that the court cannot confirm a plan of reorganization unless all creditors in a class accept the plan or each creditor in the class will receive an amount equal to that which it would receive in a Chapter 7 proceeding. Bankruptcy Code § 1129(a)(7)(A) (11 U.S.C. § 1129(a)(7)(A).

[8] See note 6, *supra*.

holders whole. The Court of Appeals properly found that the trustee's plan was not fair and equitable and that straight debentureholders were entitled to interest on overdue installments of interest under federal bankruptcy law.

II. The Court of Appeals' Decision is Not in Conflict With the Decisions of This Court or the Decisions of the United States Court of Appeals for the Second Circuit.

A. Butner v. United States *Has no Bearing on the Issue before This Court.*

The Court of Appeals did not ignore state law in reaching its decision. The Court of Appeals explicitly rejected the claims asserted by the Committee under New York law (P-14a, 15a) and consequently held that straight debentureholders were not entitled to interest on overdue installments of interest at the contract rate of nine percent computed from the debtor's default in 1974. Rather, the Court of Appeals held that as a matter of federal law the straight debentureholders were entitled only to interest on overdue installments of interest at the statutory rate of eight percent computed from the commencement of the Chapter XI proceeding in 1976.

In *Butner* v. *United States*, 440 U.S. 48 (1979), this Court held that a mortgagee is not entitled to an automatic security interest in rents and profits under federal bankruptcy law where state law would deny such a security interest without some further action, for example foreclosure, by the mortgagee even where such action is barred by the debtor's bankruptcy. *Id.* at 56.

Butner is inapposite where, as here, the straight debentureholders are asserting a right, neither anticipated nor created by state law, to be compensated for the injury suffered by the intrusion of federal bankruptcy law. *Butner* goes no further

than to hold that, as between creditors of an insolvent estate, the relative priorities established by state law will be maintained under the bankruptcy law. Thus, a partially secured creditor cannot by claiming an "automatic" security interest improve its position over unsecured creditors by recourse to the bankruptcy courts. *Butner* does not hold that a bankruptcy court administering a solvent estate can ignore the mandate of the absolute priority rule to the detriment of creditors by ignoring the delayed satisfaction of a contractual right to interest.

B. *The Court of Appeals' Construction of* Vanston Bondholders Protective Committee *v.* Green *is Consistent With the Recent Decisions of the Second Circuit.*

The petitioners cite *In re Realty Associates Securities Corp.*, 163 F.2d 387 (2d Cir.), *cert. denied*, 332 U.S. 836 (1947) and *Empire Trust Co.* v. *Equitable Office Building Corp.*, 167 F.2d 346 (2d Cir. 1948) as evidence of a conflict between the First Circuit and Second Circuit Courts of Appeals over the issue of interest on overdue interest. That such a conflict might have arisen during the 1940's is possible but, as the petitioners note in a passing footnote, both *Realty Associates* and *Empire Trust* have since been distinguished by the Second Circuit.

In *Ruskin* v. *Griffiths*, 269 F.2d 827 (2d Cir. 1959), *cert. denied*, 361 U.S. 947 (1960), the Second Circuit reversed a district court's order disallowing a creditor's claim to an increased rate of interest after default. The district court had relied on the Court's decision in *Vanston*, *supra*. The Second Circuit stated:

> Even if we agreed with the court below that a Supreme Court precedent dealing with an obligation for interest on interest falling due because of an equity court's stay

> order is equally applicable to a claim based upon a contractual provision for additional simple interest arising because the debtor sought the intervention of the bankruptcy laws, a question we need not now decide, we would still have to distinguish *Vanston* on what we find was a basic ground of that decision. In *Vanston*, the debtor was insolvent, and in our case it appears the debtor is solvent. In *Empire Trust Co.* v. *Equitable Office Bldg. Corp.* . . ., we avoided a resolution of the effect of *Vanston* upon parties to a reorganization proceeding involving a solvent corporation, but the issue is squarely before us now, and we hold that the Supreme Court did not intend that the principle enunciated by it in *Vanston*, in a contest between creditors, should be applied to a contest between a debtor's creditor and its stockholders.

269 F.2d at 830 (citation omitted).

Significantly, the *Ruskin* court relied primarily on the dissenting opinion of Judge Clark in *Realty Associates, supra*, to support its construction of *Vanston*.

And in *Corbin* v. *Federal Reserve Bank of New York*, 629 F.2d 233 (2d Cir. 1980), *cert. denied*, 450 U.S. 970 (1981), the Second Circuit stated:

> In *Empire Trust Co.* v. *Equitable Office Bldg. Corp.* . . ., the court merely held that indenture provisions for the payment of interest on interest were invalid under New York law. And *Ruskin* v. *Griffiths* . . . enforced a contract providing for a post-default increase in interest, *even assuming that this was the equivalent of interest on interest* . . . because the estate was solvent.

629 F.2d at 238 (emphasis added).

Perhaps because of the paucity of solvent debtors, the Second Circuit's movement away from *Realty Associates* and *Empire Trust* has been episodic, but the movement is clear. Indeed, it is apparent from *Ruskin* that the Second Circuit would enforce a contractual interest on interest provision without reference to underlying state law, a step the First Circuit has refused to take.

The Court of Appeals' decision in this case, therefore, is neither unprecedented or in conflict with the decisions of the Second Circuit.

III. The Court of Appeals' Decision Will Not Encourage the Commencement of Additional Bankruptcy Proceedings.

The petitioners envision teems of secured creditors flooding into the bankruptcy courts to take the supposed advantageous position accorded them by the Court of Appeals' decision. Nothing is more implausible. No secured creditor would avoid foreclosing on the property of a *solvent* debtor and instead seek relief under the Bankruptcy Code, to be paid interest at the legal rate *only* to the extent that the creditor did not receive interest payments during the course of the proceeding and *only* if the debtor remained solvent for that period. Indeed, although the petitioners state that creditors whose contractual rate of interest is below the legal rate will avidly commence bankruptcy proceedings (P-27), if the debtor is in default such creditors could achieve the same result by commencing a civil collection proceeding. And if the debtor is not in default, the creditor has no grounds on which to commence a bankruptcy proceeding.

The Court of Appeals' decision affords relief only to creditors who, by the debtor's own acts, have been prevented from collecting the sums due them during the course of a bankruptcy proceeding where to deny relief would give an inequitable

benefit to the debtor or its stockholders. The decision of the Court of Appeals should be sustained and certiorari should be denied.

Conclusion.

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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